# DOW THEORY LETTERS INC.

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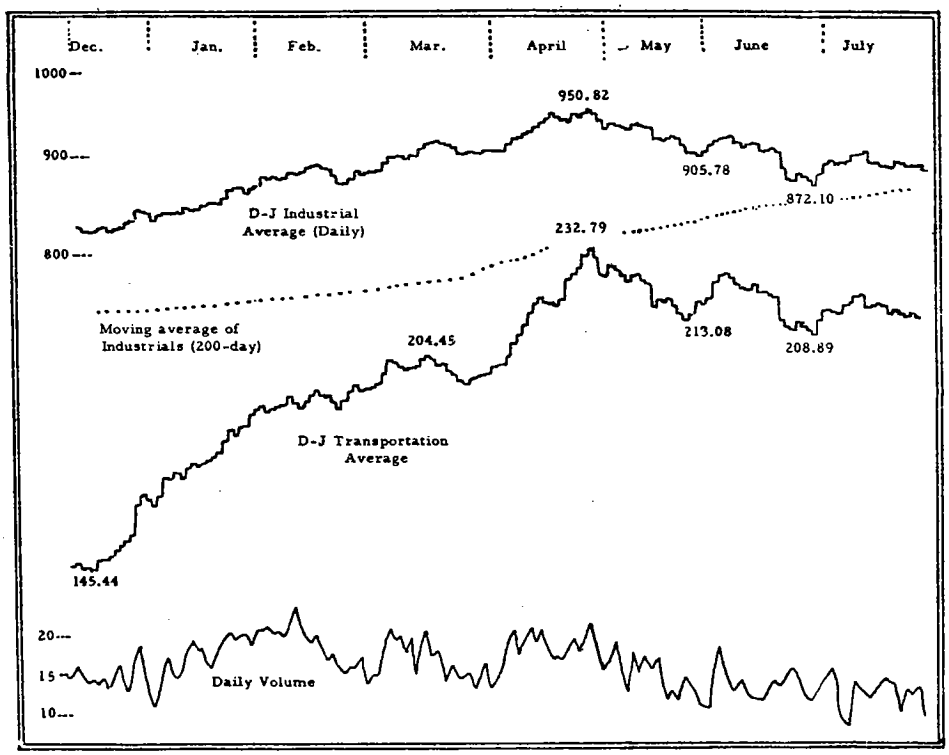
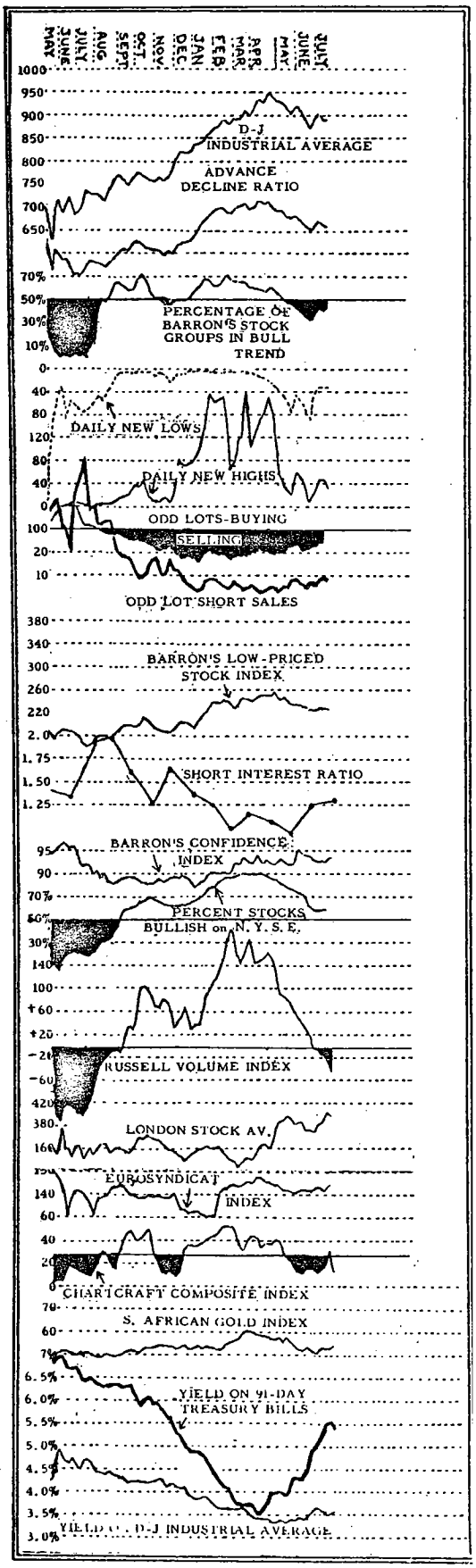
THE PICTURE: The most outstanding and obvious trend in the U.S. today does not show itself on Wall Street. It appears in the economy in the form of inflation. Last week the phone workers received a three-year contract boosting average wages 33%. A day earlier Austin Co. of Cleveland, the international engineering outfit, announced that their long-term index of construction costs had leapt 11% over the last 12 months. Like a ship without a rudder, the U.S. economic machine lurches and rolls as it is wracked with one of the longest and worst inflationary storms in its history.

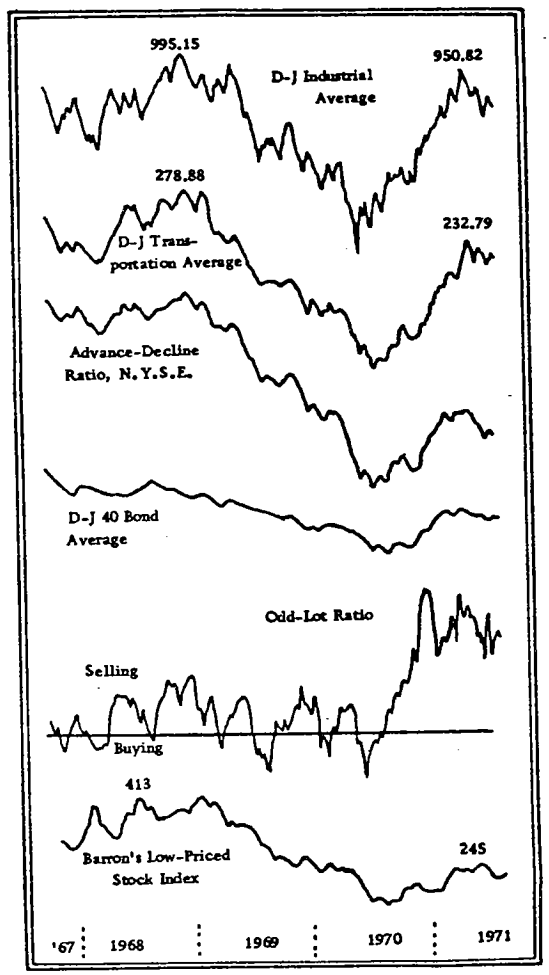
This leaves the average investor on the horns of a cruel dilemma. Should he put his money in "things," stocks, art objects, stamps, land, anything, or should he try to save his money for what appears to be higher and higher living costs and bills which grow larger with almost every mailing.

The month of June brought another net loss to the mutual fund industry as fund holders continued to turn in their shares, either through confusion, disillusionment or because they need the money to send Curtis to college or to pay the next installment on the house or car. Actually, this may be a far too-mild view of the situation. My friend Eliot Janeway (in his latest Janeway Service report) states: "The consumer panic--it's nothing less!--is a case of the unemployment fear being father to the savings thought. Everyone in the line of fire expects to be shot down." And as to that morale-boosting device known as overtime, Janeway reports, "There's none left anywhere in the economy."



Page 2 On page 2 I show a chart of six important market indicators (courtesy of Comparative Market Indicators, Box 1557, Bellevue, Wash.), and it is notable that not one of these has bettered its early 1971 peak. Four of these indicators are based on price, a fifth is based on the advancing or declining tendencies of all listed stocks on the N.Y.S.E. (this is the advance-decline ratio), and the sixth is based on public sentiment (the odd-lot ratio).




From the Dow Theory standpoint, the April peaks of 950.82 (Industrials) and 232.79 (Transports) represent the bullish points on the upside. A continuation of the 1970-71 recovery requires that both of the Averages better these earlier points. On the bearish side, a breaking of the June lows of 873.10 and 208.89 would undoubtedly spell "finis" to the summer rally, and indicate that the market was looking ahead to a stormy fall and winter, rather than a happy conclusion to the summer of '71.

I am not a great advocate of the "calendar approach" to the market. Nevertheless, I would like to note that it is unusual for the Averages to record highs for the year in April, and then fail to better those peaks by late summer (or late-July) as is the case this year (see page 1 chart).

Going back over history, this is what happened in 1930, a year when the Dow hit a peak on April 17. A decline carried to June 24. A new rally then stretched into September, but the June-September rally ended far short of the April peak. From September, 1930 on, the market went into a collapse. It should be noted that the Averages struck peaks on April 28 this year, and the low was recorded on June 28. If the current rally cannot get going between now and September, I would say that we are in for a very bad final quarter.

In 1936 the Dow touched a high for the year on April 6. A decline ensued, but by July of that year the April peaks had been surpassed, and the market rose into March of the following year. Incidentally, following March of 1937 the market declined to a June low, and when the rally into August failed to better the March high, the crash of 1937 resulted.

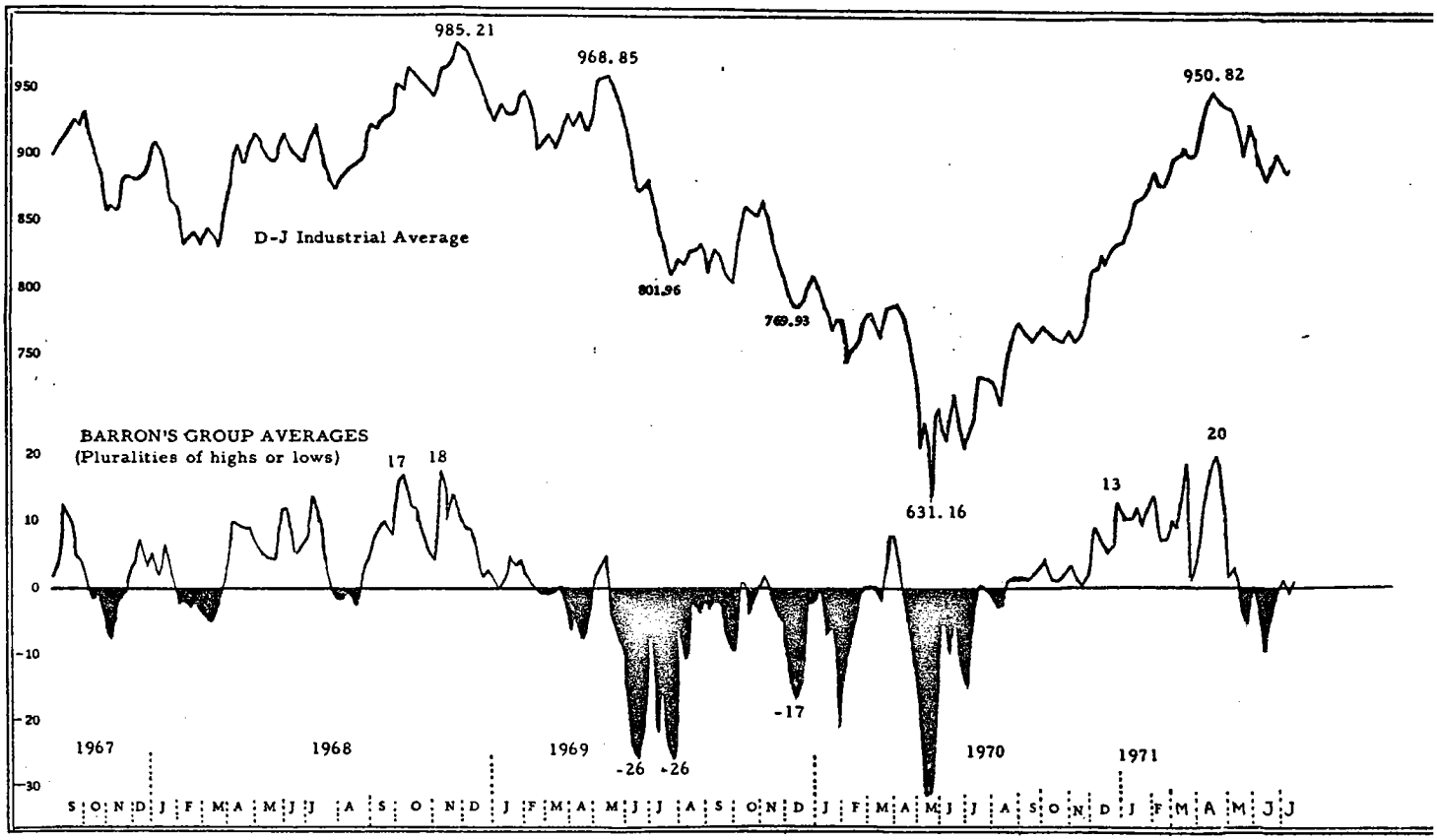
Again, on April 8, 1940, the Dow touched a high for the year. In May a violent decline (based on the fall of France) occurred, but the subsequent June to November rise failed to better the April highs. The market declined from November, 1940, to its bear market bottom in April, 1942.

On April 6, 1956, the Dow topped at the famous 521.05 peak. A decline carried into late-May, and the ensuing summer rally brought the Dow back to an August peak of 520.95, just 10¢ under the April high. The Dow rallied and declined widely during the rest of 1956 and into July, 1957. On July 12, the Dow touched 520.77, forming the famous triple top, but the April, 1956, peak was never surpassed. From July to October, 1957, the market went into a vicious collapse.

Conclusion: When an advancing market records highs for the year in April, the action which follows can be very significant. If by late summer (say July or August) the April peaks have been bettered, the market will probably continue strong through the end of the year and even into the next year. But if, by late summer, the April peaks have not been surpassed (as in 1930, 1940, and 1956), the indications are not good. The years 1930 and 1940 were both primary bear market years, and the failure to better the April highs resulted in year-end collapses. The year 1956 was a primary bull market year, but even then, when the April peak was not bettered, the market tried until July, 1957, then caved-in.

The April, 1971, highs for the Averages were 950.82 (Industrials) and 232.79 (Transports). It is now late-July and the Averages have not yet bettered their April peaks. If this situation continues until August and September, then the implications will be ominous for year-end 1971 and 1972.

SHORT TERM: The majority of stocks as reflected in the advance-decline ratio continue to act worse than the Dow. This suggests that any rally from here will lack technical strength. I do not dismiss the possibility of a token "summer rally" into August, but as matters stand now it appears to me that the next major or extended movement will be down. The latest Dow short interest ratio figure (July) is a very bearish .51. The Russell Volume Index touched minus 47 (see page 1 chart) last week, a new low for the year. The Chartcraft Index sank to a bearish 14. An amazing number of investment services are forecasting new all-time highs by the end of the year or during 1971. A few hazard 1200 or 1500 for the Dow prior to election-time 1972. These optimists don't seem to be looking at my charts and data. But I look at theirs. And I believe they're going to be dead wrong.




GROUPS: This is a technical study which I find quite useful, since it offers such clear comparisons (see chart). Each week Barron's ("Market Laboratory") shows 35 stock groups. If any group touches a high or low for the year, it is marked with an H (new high) or an L (new low). I tabulate the plurality each week and enter it on this chart. For instance, if there were 4 new highs and 1 new low, I would enter a plus 3 on the chart for that week.

Note that during the final advance in 1968, the group index topped out in November with a reading of 18. Three weeks later the Dow topped out at 985.21. An extended decline occurred, and during the early 1969 rally the Dow got as high as 968.85 on May 14, only 17 points under the 1968 high. But the index was then giving a weak reading, showing a plus 5 for its highest level of May. That proved to be the last gasp for the market, and the entire structure gave way in a rout that lasted until May, 1970.

Now turning to the 1970-71 advance, note that the group index rose to a peak of 20 during April, 1971. This peak coincided with the recovery high of 950.82 on the Dow Industrials. Then came the decline into June, which saw a low of minus 10 for the group index. This takes us to the present and the widely-expected summer rally.

I believe the group index (as it was during 1968-69) will be very useful here in gauging the strength of any recovery, particularly one which carries near or perhaps above the 1971 peak in the Dow. A build-up in the group index to such as occurred in late-1970 would suggest continuing upside momentum, while a stalling or persistent refusal by the index to better its old high (particularly if the Dow hurdles the 950.82 peak) would indicate that the mass of the market is not willing to follow the Dow. In such cases, trouble usually follows. (It is worth noting that the best this index has registered on the "summer rally" is a plus one on the weeks ending July 9 and again on July 23).

TO THE VICTORS: Few Americans are aware of the implications of the current frantic adventure in inflation. According to the Federal Reserve Board of St. Louis, the money stock in the five months from February 10 to July 7 increased at a rate of 13.7%. In the two months from May 5 to July 7, it increased at a 15.9% rate! That is the kind of activity I would expect from a banana republic. It cannot and will not last, or it will produce inflation so frenzied that the very foundations of this economic system will todder.

Horrendous damage has already been done. The damage has been done in terms of lost purchasing power, lowered productivity, the inability of the U.S. to compete. Here are a few figures worth pondering. Japan is now literally gobbling up whole

 segments of U.S. industry. Japan is doing this because it can produce at fantastically competitive prices (did you know that Japan is on a six-day, eight-hour week?) Last year Japan accounted for 25% of all TV sets sold in this country. Japan has been so successful in selling radios here that except for specialty companies, no large U.S. manufacturer of radios now exists. Honda, a single Japanese producer, sells half of all the motorcycles registered in the U.S. Yamaha is second. Ninety percent of all men's dress shirts are now produced in Japan, 50% of all men's dress suit fabric is produced overseas (most in Japan).

Germany and Japan are cutting sharply into the U.S. auto field with Japan (Datsun, Toyota, etc.) actually outpacing Germany's VW. Few people realize that inflation causes unemployment. It is estimated that for each one million cars imported to the U.S., 200,000 jobs are lost. Study these figures. In 1968 the U.S. imported 1 million cars. In 1969 we imported 1.1 million, in 1970 the figure jumped to 1.3 million, and in the 12 months ending June, 1971, the figure is 1.5 million!

The fact is that American manufacturers are facing a crisis, and few see it as yet. The figures show it, however. Machine tool orders are very low, the rate of rise in capital goods expenditures is around the slowest in a decade, after-tax profits per dollar of sales are around the low for the past 20 years.

Reserve Board Chairman Arthur Burns knows how insidious the current inflation is, and he spoke at length about it before the Joint Economic Committee. The truly incredible thing about the situation at present, is that with the biggest injection of money since World War II, the economy remains sluggish. All the Administration got for its reckless money expansion policies was more inflation, bigger budget deficits and unemployment. What happens as the brakes are placed on the current inflationary express (as they must)? That will be the story told in interest rates, dislocations, and business troubles as the bear market moves progressively into high gear.

Incidentally, after writing the above I noted that the U.S. Treasury is offering long-term bonds yielding up to 7.1%, a fantastic rate of interest for any great nation to pay. On the same day it was announced that the Treasury will pay 6.37% interest to purchase $1 billion of Eurodollars as part of the U.S. plan of soaking up Eurodollars to get them off the market. Thus, the U.S. follows its remarkable policy of flooding the world with dollars, then borrowing those dollars back and paying out high rates of interest to do so. All of which means continuing sky-rocketing expenses for the "sick colossus" of the Western World.

DIVERGENCE: Let's start off with this little clip from the July 8 Wall Street Journal. It provides us with a glimpse of the fierce "in-fighting" which is going on within the Government regarding whether the people should be told the truth or whether they should be told what the Administration wants them to hear. It seems as if the truth is, as usual, going by the wayside.

**ILL FEELING spreads among Nixon's economic policy makers.**

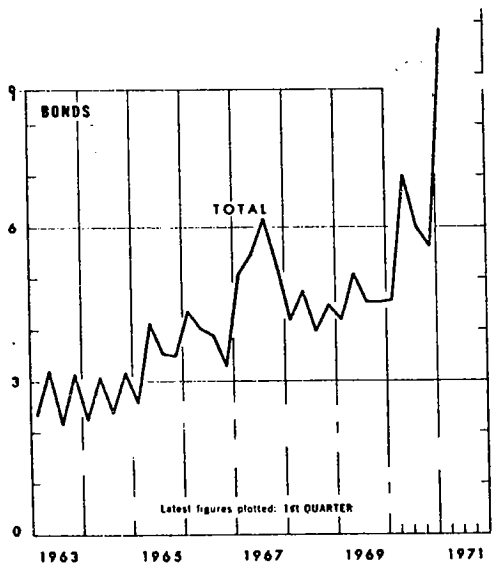
One question: How long will McCracken stay as chairman of the Council of Economic Advisers? Its prestige sags with naming of Treasury's Connally as top economic spokesman, Nixon's rejection of council advice for more fiscal stimulus. Supporters fear the council may be heading into an era of declining influence; it's the agency most apt to agitate for greater economic growth.

White House pressures for glowing economic interpretations of data could speed McCracken's exit. The administration already muzzles the less optimistic economists; several were barred from comments on the latest unemployment figures. One ranking economist got orders recently to "get on the team or shut up."

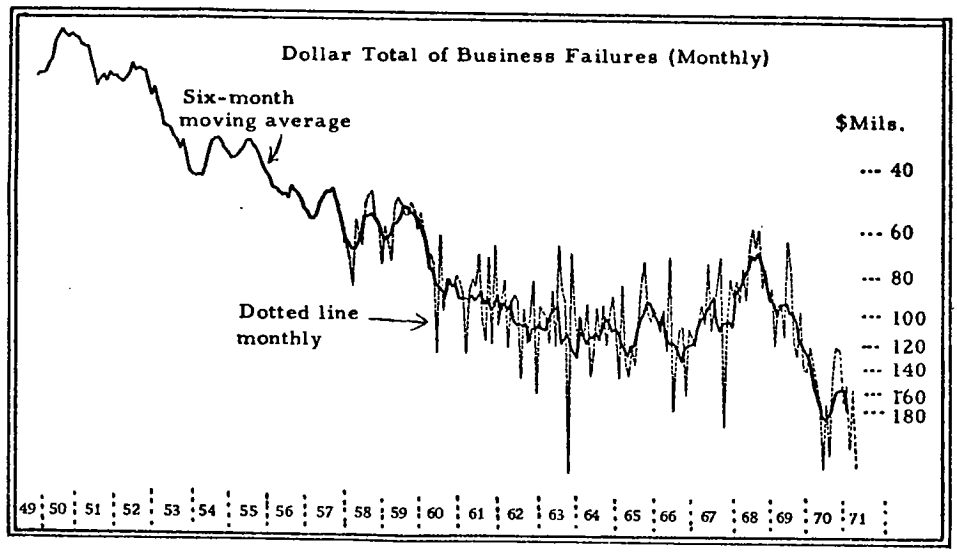
Some policy makers contend that admission of economic disappointments might dash consumer confidence, derail the recovery.

I have always liked charts, and I believe that most of my subscribers have developed a healthy respect for them. For charts have a tendency to cut through the verbiage, the nonsense, the propaganda, and show you what is really going on.

I mentioned the ominous implications of debt in the last report, and since then my Federal Reserve Chart book has come in. One chart which I want to reproduce is the one showing new corporate bonds issues (in $billions), and this is included on this page. Note that the latest plotting has broken out of the upper chart boundaries above $9 billion, and this is the first quarter, 1971, entry. The fact is that in their effort to raise money for liquidity, new building and other purposes, corporations are going on a continuing debt-building binge, and every dollar of this debt must be sustained by earnings. In other words, this rising tower of debt must be supported. Within the context of the current adverse profit climate, I view this as a very bearish trend.



The second chart I want to draw attention to is the BCD's (Dept. of Commerce) chart of business failures. Here we see a 6-month moving average of failures (total failure liabilities shown in $millions) The dotted line is the actual monthly figures and the latest reading includes May, 1971. It is obvious that business failures are now skyrocketing, and they are averaging better than $180 million per month. The Penn-Central fiasco is past, and still the 6-month average continues to probe the extreme low area. I consider this, too, a most ominous situation, and one that points up the vicious problems that beset business today.




It should be remembered that large corporations, by and large, tend to do better than medium-sized or smaller corporations, and when the total profit picture in the U.S. is considered, the big corporations are now pulling the level up a bit from last year while at the other extreme many of the medium and smaller corporations are doing very badly. The place which documents how badly the "bad ones" are doing is the bankruptcy chart shown here. The chart shows that the bankruptcy end of the business scale is doing a booming business with no sign of a change in trend.

Note particularly how the 1966-69 Fed opening of the money spigots helped the bankruptcy picture, and failures actually receded over a two-year period. Now note that nothing of the kind has occurred so far, although the money spigot was opened wide during the last year.

GOLD: The U.S. gold reserves are being slowly but most definitely nibbled away, Counting what we owe the I.M.F., we have less than the critical $10 billion of gold. Switzerland alone, including its latest ($50 million) June purchase, has bought $125 million of U.S. gold from the U.S. this year. Interest in gold is rising sharply. The N.Y. Mercantile Exchange is planing to institute trading in placer gold (legal for U.S. citizens), and the West Coast Commodity Exchange started (but was halted from) trading pre-1934 gold coins in the form of futures (which the Treasury now says is illegal). U.S. demand for gold English sovereigns and gold "double eagles" is booming.

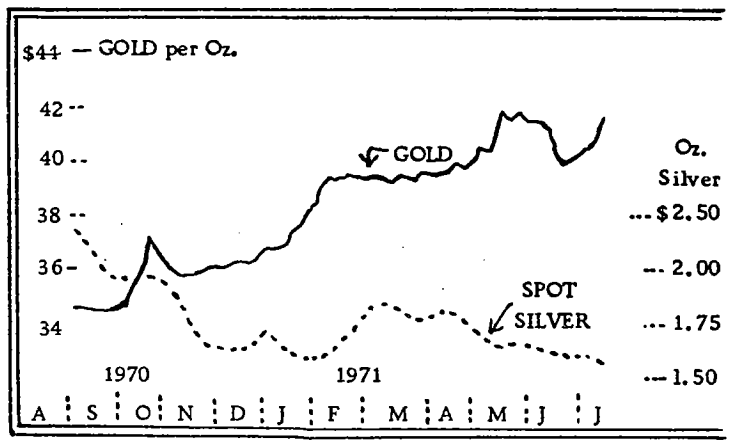
South Africa, hardly immune to the furor, is minting the Krugerrand, each coin containing one troy ounce of gold. This coin has been circulated where legal for 8 months. So far, 73,000 of these coins have been sold in S. Africa and 359,000 have been sold abroad. As the world monetary system starts creaking, I expect sales of Krugerrands coins to boom.

Question: What can Americans do to protect themselves against a rise in the price of gold?
Answer: The only way I know to protect oneself against a rise in the dollar price of gold is to purchase shares in gold mines (since holding of gold bullion is not legal in the U.S.). This also has an advantage over holding gold bullion in that one receives dividends on gold shares whereas one loses interest increments by holding gold bullion instead of currency. On the other hand, gold purchased at or near $35 per ounce has a floor under it (assuming gold ever goes down to that price again), whereas gold shares can fluctuate widely.

Question: What about holding American Depository Receipts (ADR 's). Is this safe?
Answer: I believe ADR's are relatively safe. When you buy Western Deep Levels for instance, you pay a 15% interest equalization tax in addition to the price of the shares as per that day in London (where the actual shares are traded). Morgan Guarantee Trust receives the actual shares, and you are issued a receipt or ADR stating that you own these shares. However, once the ADR tax has been paid these ADR may be sold from one person to the next in the U.S. at the tax-plus premium price. In other words, each new buyer does not pay the tax.

Now, the oft asked question is, if the U.S. embargoes gold, what happens to my ADR's? I would think that the U.S. would be perfectly happy to have you sell these, since each sale would represent a sale of assets abroad and bring in money to the U.S. However, it could be that the U.S. would prohibit purchase of foreign assets (this would be a loss of U.S. captial), which could mean no more additional purchases of foreign gold shares. If this were to occur, I would think that ADR's could go for a premium, since the supply would be limited.

If the price of gold were raised, dividends on gold shares would undoubtedly boom, and the U.S. holders would receive this new source of capital. Therefore, I would think that the U.S. would be anxious to have U.S. citizens hold what gold shares they have or sell them (each of these processes would bring in capital), but the U.S. would not want to lose capital by allowing additional purchases of foreign gold shares.



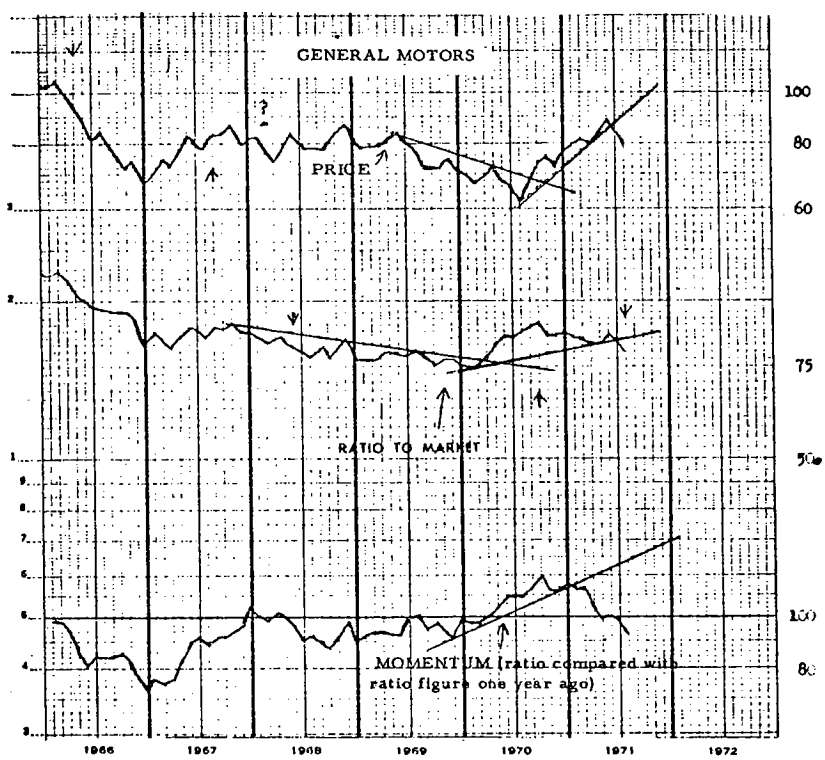

Holding ADR's here is legal, and if one does hold ADR's he is, as usual, at the mercy of the U.S. Government and whatever it decides to do in case of an emergency. ( I might add that I have no idea what the Government might ultimately decide to do). I have no doubt that many U.S. citizens hold gold shares in overseas accounts (in secret) and do not declare dividends. This is illegal, and I have no wish whatever to recommend any illegal procedure. I merely regret that this whole discussion is necessary, and that we have a situation wherein I am receiving letter after letter from individuals who are frightened at what is happening and increasingly suspicious of the next Government move. It is a sad situation when millions of Americans, living on fixed incomes, are being wiped out by inflation, and other millions are wondering what to do to simply protect their earnings power.

I know of no case of rampant inflation within a nation which did not end in some sort of disaster. We are on that route now, and there is no leader on the horizon who is taking a real stand against inflation. In the end, Gresham's Law will force the stand. Gold will win as it has for 5,000 years. Those who understand this will probably do best before the mad party is over.

The gold-silver price chart is included here, and I blush to say that the first appearance of this chart was marred by a "goof" on the left-margin which was slightly out of kilter. This week's chart has been corrected, and you will note that on Monday (July 19) the London price of gold rose to $41 for the first time in two months. I would consider anything over $42 (which would be over the May peak) a significant breakout, and the beginning of an attack on the 1969 peak price of just under $44.

(For new subscribers, I will add that I like the following gold shares: Dome, Campbell, Red Lake, Homestake, Giant Yellow Knife, and the S. African shares of Western Deep Levels, President Brand, President Steyn, Free State Geduld.)

STOCKS: I have been warning about the action of bellwether General Motors in recent Letters. Now, from Ray * Signals (42 B'way, N.Y.C. 10004) comes their latest chart which I consider very significant. The top line shows the price of GM, and it is breaking below a one-year trendline. The middle line shows relative strength of GM against the broad Standard & Poor Average, and here again the trend is reversing to the downside. The third line shows the relative strength line as a percentage of its value one year ago (this is the momentum line).




Such trends are often long-lasting, and they are now occurring in the world's largest manufacturer. I consider that the auto business during the 1970's may go the way of the Steel business during the 1960's. People still use alot of U.S. steel products, but they also use alot of steel imports, and U.S. steel companies have been on a profit slide for years.

NOTE: I am taking a few days off to go up to San Francisco. Therefore, the next Letter will be a few days late, and it will be mailed on August 10 (since I want to give myself enough time to put it out without rushing.) I am also preparing an extra piece (about me) for a mailing sometime next month. This will concern itself with how I've lived and some of the things I've learned.